How Non-Probate Assets Can Affect Your Estate Plan: A Few Cautionary Tales

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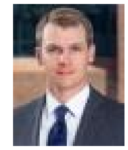

When you think about the control of your possessions and assets after your death, you probably think of a Will and probate. A Will is a written, legally enforceable declaration that states how you wish your assets to be distributed at death and that usually designates an Executor to carry out those wishes. You may also use your Will to nominate a guardian to care for minor children.

Probate is the name of the formal legal process for proving and administering a Will. During probate administration, the Executor appointed in the Will or otherwise appointed by the Clerk of Court pays the outstanding debts of the deceased person (the "decedent") and distributes the decedent's remaining assets to the named or identified beneficiaries in an orderly manner. The Executor's actions are court supervised (in North Carolina, by a Clerk of Court), and inventories and periodic accountings of the decedent's assets must be filed with the Clerk of Court to facilitate the required oversight.

Probate Assets

While a Will and the corresponding probate administration are generally the mechanisms we think of for distributing a decedent's estate, a Will only governs the passage of certain, not all, of a decedent's assets. These assets are known as "probate assets." Probate assets include:
Individually owned assets;

- Assets owned as a tenant in common with one or more other persons;
- Assets payable to the decedent's estate because the decedent designated the decedent's estate as the beneficiary of the assets or because the decedent did not designate anyone as beneficiary of the assets;
- Amounts owed to the decedent; and,
- Household furnishings and other personal property.

The law dictates another process for the distribution of these assets that controls in the absence of a Will, called "intestate succession." The intestate succession process, which distributes the decedent's assets in a way that the law "presumes" the majority of people would prefer, is outside the scope of this article.

Other than probate assets and assets distributed by intestate succession, however, there exists yet another large universe of assets which pass at death, not by the Will of the decedent, or as the law presumes a decedent without a Will would want, but by contractual provisions directly associated with their ownership. Such assets are not governed by a Will or intestate succession and, thus, are not subject to probate administration. These assets are called "non probate assets."

Non-Probate Assets

Non probate assets include:

- Assets owned in the decedent's sole name but which have a payable on death ("POD") or transfer on death ("TOD") designation;
- Assets owned jointly by the decedent with a spouse or others, with rights of survivorship;
- Assets owned with a spouse in a special type of joint ownership called tenancy by the entirety;
- Assets owned at the time of the decedent's death by a Revocable Living Trust set up by the decedent; and,
- Assets owned by the decedent through contract rights which are payable to a designated beneficiary at death, including IRAs, 401(k)s, annuities, and life insurance policies.

The Importance of the Distinction between Probate and Non Probate Assets

Not understanding the important differences between probate assets and non probate assets and how they pass at death can lead to unexpected and unfortunate results in the distribution of your assets at death. On one hand, you may take care to invest your time and money on the preparation of a Will to give effect to your final wishes, only to have those wishes dashed or frustrated by your failure to take into account your non probate assets.
On the other hand, you may understand that non probate assets pass at death without a Will and rely on the contractual passage of those assets as a Will substitute, but overlook how unanticipated contingencies can ruin your plans. A few such scenarios are illustrated below.

Scenario 1: Joint Accounts with Rights of Survivorship Undermines Will

Ten years ago, after her husband died, Angela updated her Will to leave her estate in equal shares to her daughter and two sons. She now lives in an assisted living facility. Her principal asset is a large investment account. She also has a cash in cash out checking account. Over the years, it has become increasingly difficult for Angela to pay her bills and manage her investments. Angela's daughter, the only child who lives nearby, starts to help Angela manage her affairs. To make it easier for her daughter to help her, Angela adds her daughter to both her checking account and her investment account, making her daughter a joint owner of those accounts.

Angela did not understand that the joint ownership account documents included a survivorship provision, the practical effect of which is to convert what were probate assets into non-probate assets. A year later, Angela dies surrounded by her three children, believing that she had a properly executed Will in place by operation of which her three children would benefit equally from her estate. In fact, what happens is that Angela's sole assets, the investment account and the checking account, both pass by contract 100% to her daughter and nothing passes to her sons. This may cause a formerly loving family to become irrevocably broken, the very result Angela wanted to avoid.

This situation is fairly common-adding a child to accounts to assist with their management is easy to do and is often done without a full understanding of the implications to the account owner's estate plan. With some informed guidance, this result easily could have been avoided, while still enabling Angela's daughter to assist Angela in managing her affairs.

For example, Angela might have created an agency account instead of joint ownership accounts. Her daughter would have had authority to act with respect to the accounts, but would not have had an ownership interest in them, either before or after Angela's death. Instead, the accounts would have retained their character as probate assets and would have passed according to the terms of Angela's Will.

Scenario 2: IRA Beneficiary Designation Does Not Accomplish Per Stirpes Distribution

The term "*per stirpes*" describes a method of distribution of assets when a designated beneficiary dies before the owner of the assets. In *per stirpes* distribution, assets pass in equal shares to the asset owner's living children and the descendants of any of the owner's deceased children. In other words, if a beneficiary dies before the owner of the asset, then upon the owner's death, the survivors of the beneficiary who pre-deceased the asset owner will inherit, in equal shares, only the beneficiary's share of the asset.

Consider Barry who is a married retiree with two adult children, a daughter and a son, each of whom has two children. Like many people, Barry's principal asset is his IRA, a non-probate asset. Barry originally designated his spouse as the beneficiary of his IRA. When his spouse died, Barry updated his IRA beneficiary designation to name his two children. Tragically, Barry's son predeceased him in a car wreck. When Barry dies a few years later, 100% of his substantial IRA passes to his daughter and nothing passes to his deceased son's two children, Barry's grandchildren. This is not the result Barry wanted, as reflected by the distribution plan in his Will, which contained a "*per stirpes*" direction.

Unfortunately, Barry didn't know, or forgot, that the *per stirpes* distribution language could have been incorporated into his IRA beneficiary designation to ensure that his son's children would have shared their father's, Barry's son's, share of Barry's non-probate retirement assets when Barry died. If Barry had included the *per stirpes* provision in his IRA beneficiary designation, 50% of his IRA would have gone to his daughter, and Barry's son's two children would have shared Barry's son's 50% equally; that is, each one would receive 25% of their grandfather's IRA. This scenario highlights how relying on contractual passage of assets in lieu of affirmative planning to take into account foreseeable contingencies can lead to unwanted results.

Scenario 3: Life Insurance Proceeds, Minor Beneficiary, and Guardianship

Carolyn is divorced with an eight-year old son. She has a net worth of $1 Million. Carolyn heard that a guardian must be appointed if her son is under age 18 at the time of death because minor children legally cannot own assets directly. The appointed guardian will manage the inherited assets for her son until he turns 18, at which point all the assets will be turned over to him.

Because of the court costs and other expenses, Carolyn wants to avoid having a guardian manage her son's assets. Moreover, Carolyn is concerned about her son's ability to responsibly handle a $1 Million inheritance at age 18, believing that a more suitable age is 25. So, she has her Will prepared, providing for a trust to hold her son's inheritance until he turns 25. Carolyn appoints her sister as trustee of the trust. A few months later, with planning still on her mind, Carolyn purchases a $1 Million life insurance policy and designates her son as the beneficiary of the policy.

Carolyn dies the following year when her son is 10 years old. Per her Will, the trust is established for her son and her sister manages the $1 Million in trust assets for her son's benefit until he turns 25. Unfortunately, however, Carolyn did not fully avoid the guardianship proceeding as she wished, or protect her son from having access to a large sum of money at a young age, because the proceeds of the $1 Million life insurance policy passed directly to her son, rather than the trust.

To add insult to injury, at the guardianship proceeding, Carolyn's ex spouse, her son's father, is appointed as guardian of the $1 Million guardianship estate, an outcome Carolyn never would have wanted. The assets remaining in the guardianship estate, if Carolyn's former husband leaves any to be had, also will be distributed outright to her son when he turns 18, not at the more mature age of 25, as Carolyn wanted.

Both of these results were unintended, as evidenced by the planning Carolyn put into her Will by appointing her sister to manage her son's inheritance until age 25. Carolyn's plan would have come to full fruition had she designated her life insurance proceeds to pass to her son's trust, rather than directly to him.

Non-probate assets often are a large part of a decedent's overall estate. Unintended results, however, can result from an incomplete understanding of how these assets pass at death. An estate planning attorney can help devise a comprehensive and coordinated plan that accounts for both probate and non probate assets. Such a plan should protect all of a person's wishes for the distribution of their assets at death.

For further information regarding the issues described above, please contact a member of the Trusts & Estates practice: Virginia Carter, Eldridge Dodson, Zac Lamb, Gregory Peacock, John Sloan, Matt Thompson, or Peter von Stein.

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